DEPARTMENT OF STATE REVENUE

04-20110433.LOF

Letter of Findings: 04-20110433
Gross Retail Tax
For the Year 2010

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ISSUES

I. Recreational Vehicle – Use Tax.

Authority: IC § 6-2.5-1-2; IC § 6-2.5-2-1; IC § 6-2.5-3-2(a); IC § 6-2.5-4-1(b), (c); IC § 6-8.1-5-1(c); 45 IAC 2.2-3-4; Gregory v. Helvering, 293 U.S. 465 (1935); Lee v. Comm'r, 155 F.3d 584 (2d Cir. 1998); Horn v. Comm'r, 968 F.2d 1229, (D.C. Cir. 1992); Comm'r v. Transp. Trading & Terminal Corp., 176 F.2d 570 (2d Cir. 1949); Helvering v. Gregory, 69 F.2d 809 (2nd Cir.1934); Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044 (Ind. Tax Ct. 2002); USAir, Inc. v. Ind. Dep't of State Revenue, 623 N.E.2d 466 (Ind. Tax Ct. 1993); Fell v. West, 73 N.E. 719 (Ind. App. 1905); Dept. of Treasury v. Dietzen's Estate, 21 N.E.2d 137 (Ind. 1939); Letter of Findings 04-20100111 (March 29, 2010); Letter of Findings 04-20100299 (July 28, 2010); Letter of Findings 04-20100175 (August 23, 2010).

Taxpayer disagrees with the Department of Revenue's decision imposing a sales/use tax assessment on the purchase of a recreational vehicle.

II. Tax Administration – Fraud Penalty.

Authority: IC § 6-8.1-10-4; 45 IAC 15-5-7; 45 IAC 15-11-2(b); 45 IAC 15-11-4; Black's Law Dictionary (7th ed. 1999).

Taxpayer challenges the Department of Revenue's decision imposing a 100 percent fraud penalty stemming from the use tax assessment on the purchase of a recreational vehicle.

STATEMENT OF FACTS

Taxpayer purchased a recreational vehicle from a Florida dealership. No sales tax was paid to Florida at the time of the transaction. Taxpayer arranged for a Montana attorney to establish a Montana LLC to hold title to the vehicle. The only members of the LLC are Taxpayer and his spouse. The Indiana Department of Revenue ("Department") issued a proposed assessment for sales/use tax. Taxpayer disagreed with the proposed assessment and submitted a protest to that effect. An administrative hearing was conducted during which Taxpayer and Taxpayer's representative explained the basis for the protest. This Letter of Findings results.

I. Recreational Vehicle – Use Tax.

DISCUSSION

The Department assessed use tax on the purchase of the recreational vehicle. The Department imposed use tax after determining that no sales tax had been paid on the purchase of the recreational vehicle.

Taxpayer disagrees relying partly on the proposition that no sales tax was owed to Florida or Montana and that the Department is required to defer to those states under the Full Faith and Credit Clause of the United States Constitution. (U.S. Const. art. IV § 1). Taxpayer protests that the recreational vehicles were titled by a Montana LLC and that all legal documents establishing the existence of the LLC were properly filed in Montana. Taxpayer additionally maintains that the vehicle was used primarily outside Indiana.

As a threshold issue, it is the Taxpayer's responsibility to establish that the existing tax assessment is incorrect. As stated in IC § 6-8.1-5-1(c), "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." As Indiana courts have long held, "In construing tax statutes a liberal rule of interpretation must be indulged in order to aid the taxing power of the state." Dept. of Treasury of Ind. v. Dietzen's Estate, 21 N.E.2d 137, 139 (Ind. 1939). "The statutes of this state relating to the assessment and collection of taxes are liberally construed in favor of the taxing powers." Fell v. West, 73 N.E. 719, 722 (Ind. App. 1905).

The sales tax is imposed by IC § 6-2.5-2-1, which states:

(a) An excise tax, known as the state gross retail tax, is imposed on retail transactions made in Indiana.

(b) The person who acquires property in a retail transaction is liable for the tax on the transaction and, except as otherwise provided in this chapter, shall pay the tax to the retail merchant as a separate added amount to the consideration in the transaction. The retail merchant shall collect the tax as agent for the state.

The use tax is imposed under IC § 6-2.5-3-2(a), which states:

(a) An excise tax, known as the use tax, is imposed on the storage, use, or consumption of tangible personal property in Indiana if the property was acquired in a retail transaction, regardless of the location of that transaction or of the retail merchant making that transaction.

The Department's regulation, 45 IAC 2.2-3-4, provides:

Tangible personal property, purchased in Indiana, or elsewhere in a retail transaction, and stored, used, or otherwise consumed in Indiana is subject to Indiana use tax for such property, unless the Indiana state gross retail tax has been collected at the point of purchase.

The use tax is functionally equivalent to the sales tax. See Rhoade v. Ind. Dep't of State Revenue, 774 N.E.2d 1044, 1047 (Ind. Tax Ct. 2002). By complementing the sales tax, the use tax ensures that non-exempt retail transactions (particularly out-of-state retail transactions) that escape sales tax liability are nevertheless taxed. Id.; USAir, Inc. v. Ind. Dep't of State Revenue, 623 N.E.2d 466, 468–69 (Ind. Tax Ct. 1993). The use tax ensures that, after such goods arrive in Indiana, the retail purchasers of the goods bear their fair share of the tax burden. To trigger imposition of Indiana's use tax, tangible personal property must (as a threshold matter) be acquired in a retail transaction. Rhoade, 774 N.E.2d at 1048. A taxable retail transaction occurs when; (1) a party acquires tangible personal property as part of its ordinary business for the purpose of reselling the property; (2) that property is then exchanged between parties for consideration; and (3) the property is used in Indiana. See IC § 6-2.5-1-2; IC § 6-2.5-4-1(b), (c); IC § 6-2.5-3-2(a).

In its contact letter to the Taxpayer, the Department explained that use tax was being assessed because "sales tax was not paid to the vendor." The Department recognized that the vehicle(s) "was titled in the state of Montana in the name of a LLC" but that the Department "believed the RV is the only asset of the LLC and the LLC serves no other purpose but to avoid Indiana sales/use taxes due for vehicles that are otherwise garaged, serviced, and/or driven in Indiana by you as Indiana residents."

Taxpayer states that the Taxpayer "is an individual, who had no part, individually, in the purchase of this RV from a Florida dealer" and "there is no legal basis to assess or tax him individually." Taxpayer correctly points out there is nothing in the law which requires that a taxpayer maximize his or her tax liability but that "[a]nyone may so arrange his affairs that his taxes shall be low as possible; he is not bound to choose that pattern which will best pay the Treasury; there is not even a patriotic duty to increase one's taxes." Helvering v. Gregory, 69 F.2d 809, 810 (2nd Cir.1934).

However, it should also be pointed out that in the Supreme Court decision Gregory v. Helvering, 293 U.S. 465 (1935), challenging the previously cited decision, the Court stated out that in order to qualify for favorable tax treatment, a business reorganization must be motivated by the furtherance of a legitimate corporate business purpose. Id. at 469. A business activity undertaken merely for the purpose of avoiding taxes was without substance and "to hold otherwise would be to exalt artifice upon reality and to deprive the statutory provision in question of all serious purpose." Id. at 470.

The courts have subsequently held that "in construing words of a tax statute which describe [any] commercial transactions [the court is] to understand them to refer to transactions entered upon for commercial or industrial purposes and not to include transactions entered upon for no other motive but to escape taxation." Comm'r v. Transp. Trading & Terminal Corp., 176 F.2d 570, 572 (2d Cir. 1949), cert. denied, 338 U.S. 955 (1950). "[T]ransactions that are invalidated by the [sham transaction] doctrine are those motivated by nothing other than the taxpayer's desire to secure the attached tax benefit" but are devoid of any economic substance. Horn v. Comm'r, 968 F.2d 1229, 1236-7 (D.C. Cir. 1992). In determining whether a business transaction was an economic sham, two factors can be considered; "(1) did the transaction have a reasonable prospect, ex ante, for economic gain (profit), and (2) was the transaction undertaken for a business purpose other than the tax benefits?" Id. at 1237. The question of whether or not a transaction is a sham, for purposes of the doctrine, is primarily a factual one. Lee v. Comm'r, 155 F.3d 584, 586 (2d Cir. 1998).

Taxpayer sets out putative reasons for titling a recreational vehicle in Montana but also points out that Montana does not require a "business purpose to create or organize a Limited Liability Company" and that the Department is constitutionally required to extend "full faith and credit" to Montana's decision that recreational vehicles are not subject to sales and use tax. In addition, Taxpayer explains that the LLC was formed to insulate Taxpayer from any potential liability attributable to the recreational vehicle. The Department does not deny that the LLC may have been formed for a purpose other than avoiding the tax. However, in determining that Taxpayer was entitled to rely on the representations of the Montana attorney to the extent that Taxpayer did not knowingly commit fraud, the Department also reasonably notes the attorney's own representations that the purpose of establishing a Montana LLC is to "help you eliminate all sales taxes...."

Taxpayer and his spouse have Indiana driver's licenses. Taxpayer has at least one motor vehicle registered to Indiana. Taxpayer correspondence stated he returns "home" to Indiana to file his tax returns each year, to farm at his residence, and to have the warranty work performed on his recreational vehicle. Taxpayer filed an Indiana resident income tax return for the year in question and in every year for several years prior to the year in question. Finally, the Department notes that it contacted the Indiana county in which Taxpayer owns a home, and the county stated that Taxpayer claimed a Homestead Exemption, which means Taxpayer made a declaration that the Indiana home is Taxpayer's residence.

The Department is unable to agree that Taxpayer has met its burden under IC § 6-8.1-5-1(c) of demonstrating that the recreational vehicle is not used or stored in Indiana and that the Department erred in requiring an Indiana resident from paying use tax on a vehicle purchased outside the state.

Unfortunately, the Department is unable to accept the proposition that Indiana residents may avoid paying

sales and use tax on tangible personal property simply by titling that property outside the state. In this particular case, the Department is unable to agree that either the law, the facts presented by Taxpayer, or simple common sense compel the conclusion that Taxpayer should not be responsible for paying use tax on this vehicle. The Department has consistently determined as much. See Letter of Findings 04-20100111 (March 29, 2010) 20100526 Ind. Reg. 045100324NRA; Letter of Findings 04-20100299 (July 28, 2010) 20100929 Ind. Reg. 045100591NRA; Letter of Findings 04-20100175 (August 23, 2010) 20101027 Ind. Reg. 045100650NRA.

FINDING

Taxpayer's protest is respectfully denied.

II. Tax Administration – Fraud Penalty.

DISCUSSION

Along with challenging the underlying assessment of sales/use tax on the purchase of a vehicle, Taxpayer also challenges the assessment of the fraud penalty which had the effect of doubling the underlying assessment. Taxpayer states that the fraud penalty was assessed on "baseless" allegations of fraud and is "slanderous and wholly improper."

The fraud penalty is found at IC § 6-8.1-10-4, which provides:

(a) If a person fails to file a return or to make a full tax payment with that return with the fraudulent intent of evading the tax, the person is subject to a penalty.

(b) The amount of the penalty imposed for a fraudulent failure described in subsection (a) is one hundred percent (100[percent]) multiplied by:

(1) the full amount of the tax, if the person failed to file a return; or

(2) the amount of the tax that is not paid, if the person failed to pay the full amount of the tax.

(c) In addition to the civil penalty imposed under this section, a person who knowingly fails to file a return with the department or fails to pay the tax due under IC 6-6-5, IC 6-6-5.1, or IC 6-6-5.5 commits a Class A misdemeanor.

(d) The penalty imposed under this section is imposed in place of and not in addition to the penalty imposed under section 2.1 of this chapter.

The rule is restated in the Department's regulation at 45 IAC 15-11-4 which states:

The penalty for failure to file a return or to make full payment with that return with the fraudulent intent of evading the tax is one hundred percent (100[percent]) of the tax owing. Fraudulent intent encompasses the making of a misrepresentation of a material fact (See 45 IAC 15-5-7(f)(3)) which is known (See 45 IAC 15-5-7(f)(3)(B)) to be false, or believed not to be true, in order to evade taxes. Negligence, whether slight or great, is not equivalent to the intent required. An act is fraudulent if it is an actual, intentional wrongdoing, and the intent required is the specific purpose of evading tax believed to be owing.

Additionally, 45 IAC 15-5-7(f)(3) states:

(3) A person who files a return which makes a false representation(s) with knowledge or reckless ignorance of the falsity will be deemed to have filed a fraudulent return. There are five elements to fraud.

(A) Misrepresentation of a material fact: A person must truthfully and correctly report all information required by the Indiana Code and the department's regulations. Any failure to correctly report such information is a misrepresentation of a material fact. Failure to file a return may be a misrepresentation.

(B) Scienter: This is a legal term meaning guilty knowledge or previous knowledge of a state of facts, such as evasion of tax, which it was a person's duty to guard against. A person must have actual knowledge of the responsibility of reporting the information under contention. However, the reckless making of statements without regard to their truth or falsity may serve as an imputation of scienter for purpose of proving fraud.

(C) Deception: Deception operates on the mind of the victim of the fraud. If a person's actions or failure to act causes the department to believe a given set of facts which are not true, the person has deceived the department.

(D) Reliance: Reliance also concerns the state of mind of the victim and is generally considered along with deception. If the person's actions, failure to act, or misrepresentations cause the department to rely on these acts to the detriment or injury of the department, the reliance requirement of fraud will be met.

(E) Injury: The fraud instituted upon the department must cause an injury. This can be satisfied simply by the fact that the misrepresentation(s) caused the department not to have collected the money which properly belongs to the state of Indiana.

In order to demonstrate fraud, the department is required to prove all of the above elements are present. This must be shown by clear and convincing evidence.

(Emphasis added).

The negligence penalty is found at 45 IAC 15-11-2(b) which provides:

"Negligence" on behalf of a taxpayer is defined as the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer. Negligence would result from a taxpayer's carelessness, thoughtlessness, disregard or inattention to duties placed upon the taxpayer by the Indiana Code or department regulations. Ignorance of the listed tax laws, rules and/or regulations is treated

as negligence. Further, failure to read and follow instructions provided by the department is treated as negligence. Negligence shall be determined on a case by case basis according to the facts and circumstances of each taxpayer.

Assuming for the moment that the proposed assessment of sales/use tax was correct and that the Department properly assessed use tax on the out-of-state acquisitions the recreational vehicles, was the 100 percent penalty properly imposed?

Taxpayer conferred with a Montana lawyer to establish the LLC to hold title to the vehicle. A cursory search of publicly available information reveals that Taxpayer's attorney offers various services to its clients stating that, "These services include the areas of tax free vehicle registration.... Forming a Montana business entity (Montana LLC or Corporation) may help you eliminate all sales taxes and minimize license fees upon the purchase and registration of a recreational vehicle or any other vehicles."

The Montana Secretary of State duly "approved the filing of the documents" for the LLC. Purportedly acting as an "agent" for the LLC, Taxpayer proceeded to purchase the recreational vehicle. Taxpayer used its own money and/or took out a loan in its name to pay for the recreational vehicle. The LLC then "took possession" of the recreational vehicle. Taxpayer notes that the recreational vehicle was "titled to the Montana LLC a fact which was duly recorded and recognized by the state of Montana."

In order to sustain the imposition of the penalty, the statute requires that all five elements – misrepresentation, scienter, deception, knowledge, injury – be established. In this instance, it is sufficient to review the "scienter" requirement. The term is defined as follows:

A degree of knowledge that makes a person legally responsible for the consequence of his or her act or omissions... [a] mental state consisting in an intent to deceive, manipulate, or defraud. Black's Law Dictionary 1347 (7th ed. 1999).

However unlikely the legal contortions may have been, Taxpayer apparently consulted the Montana attorney in good faith, paid that attorney to establish a Montana LLC, and believed the attorney's explanation that establishing the LLC would allow Taxpayer to avoid paying Indiana sales or use tax. As such, it is not possible to establish – by "clear and convincing evidence" – that Taxpayer possessed the requisite "degree of knowledge" or scienter sufficient to sustain the imposition of the 100 percent penalty.

FINDING

Taxpayer's protest of the penalty is sustained.

SUMMARY

The assessment of the fraud penalty is not justified and should be abated. Taxpayer has not demonstrated that the purchase of the recreational vehicle is not subject to Indiana use tax.

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